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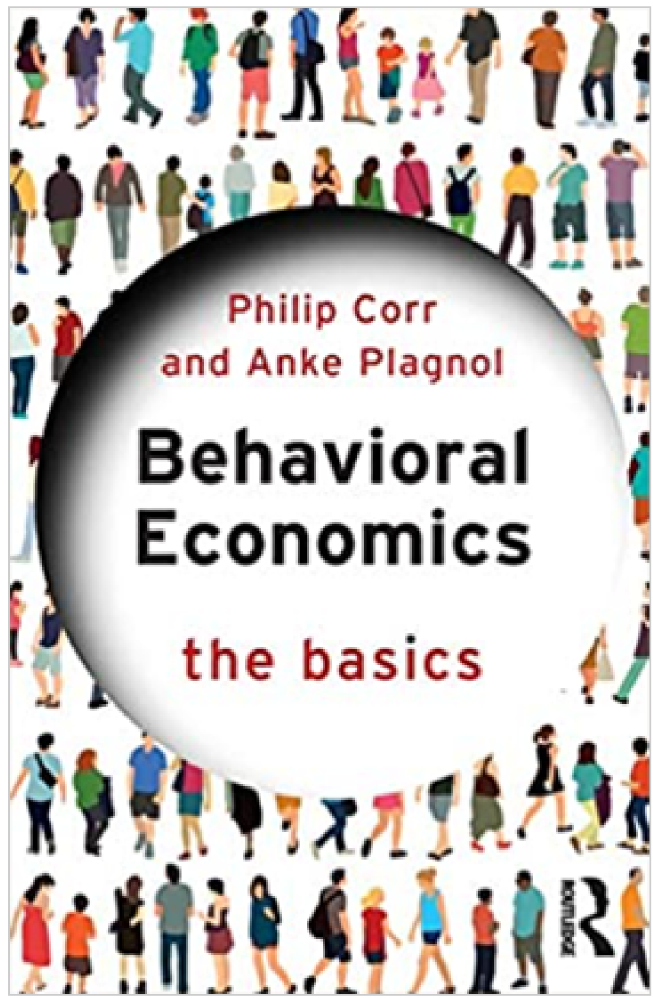
An introduction to behavioral economics: using psychology to explain economic behavior

Behavioral Economics: The Basics. By Philip Corr and Anke Plagnol. London and New York: Routledge, 2019, 250 pp., $25.95 paperback.



In this book, authors Philip Corr and Anke Plagnol provide an introduction to behavioral economics, a relatively new field of study that uses insights from psychology to understand economic behavior. Books in behavioral economics are plentiful and growing in number, ranging from rigorous and highly technical treatments of various topics in the field to accessible general-audience popular books telling stories about how people sometimes don't behave as predicted by standard economic models. *Behavioral Economics: The Basics* falls within these two extremes: it summarizes the academic literature related to behavioral economics and provides a large number of examples drawing from case studies and anecdotal evidence.

The book is organized in seven chapters. Chapter 1 introduces the basic concepts of behavioral economics and explains why this new field is important. The chapter discusses how behavioral economics uses ideas from psychology to study economic behavior and argues that standard economics often fails to explain how people behave. Corr and Plagnol mention the 2007–08 financial crisis, a macroeconomic event (at the level of the economy as a whole), as an example illustrating the limitations of standard economics, although the book focuses on microeconomics (how individuals make decisions). The authors go on to characterize standard economic theory, which is grounded in rational choice, as normative economics (making judgements on economic policy or economic behavior) and behavioral economics as positive

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economics (describing and explaining economic behavior without making judgements). While most economists won’t agree with these characterizations, some behavioral economists, including Corr and Plagnol, have adopted this controversial interpretation of normative versus positive economics.

Chapter 1 also discusses the role of behavioral economics in the economics discipline. One view, which I believe is shared by most economists, is that behavioral economics should be used to complement standard economics. In that sense, behavioral economics can explain anomalous cases of individual economic behavior. Another view, and one the authors seem to adopt throughout the book, is that standard economic theory is not only incapable of explaining economic behavior, but also that economists have not taken the criticisms from behavioral economics seriously. As one example, the authors note that economists rarely take the results of laboratory studies, which often use small samples of undergraduate students, as reliable or generalizable. While these studies may provide some interesting findings, their tiny samples (the number of participants is limited by the size of a classroom or a computer lab) and the complexity of the decisions asked of students (many of whom are not majoring in economics) render their experimental results biased and unscientific.

Chapters 2 and 3 present a brief introduction to the history of economic thought. Chapter 2 focuses on selected ideas proposed by classical economists, such as Adam Smith, David Ricardo, and Thomas Malthus, while chapter 3 focuses on modern economic theory, which the authors refer to as neoclassical economics. While these two chapters are interesting and provide useful context for the average reader, the ideas discussed in them are well known and readily available in most introductory economics textbooks.

Chapter 4 is the most informative chapter of the book and presents an excellent summary of the field of behavioral economics. While the authors base their analysis mostly on anecdotal evidence and small-scale case studies, they identify and discuss possible explanations for why people misbehave or make mistakes. The chapter starts by explaining the concept of loss aversion, which can be described as a situation in which the pleasure of receiving, for example, $100 is less than the displeasure of losing $100. The chapter then describes the endowment effect, which is valuing something we own more than the things we don’t own, and mental accounting, which refers to our tendency to assign certain amounts of money to specific uses (some money for food, some for college tuition, some for a vacation, etc.). The chapter also discusses heuristics, which the authors describe as mental shortcuts that people use to make quick decisions. One example is anchoring, or the overreliance on initial, incomplete information, such as a readily available number (the anchor), to estimate the value of an item. The chapter also describes framing effects, which refer to how people change their behavior on the basis of how information is presented to them. For example, some people may be more likely to buy ground meat if its packaging describes it as being 95 percent lean as opposed to containing 5 percent fat, even though the product purchased is identical in both cases.

In chapters 5, 6, and 7, the authors use ideas from psychology to explain human behavior. As such, these chapters have less to do with behavioral economics, because they try to explain human behavior in areas not always related to economics. Although many readers are likely to find this discussion interesting, those who are very busy may want to skim through it and select specific topics they want to explore in more detail.

Chapter 5 argues that people don’t typically maximize their own objectives and that their behavior is highly influenced by psychological factors. To support this argument, the authors present a mix of theoretical results obtained from games such as the prisoner’s dilemma and case-study evidence obtained from games such as the ultimatum game. One could argue, however, that the most likely reason why people do not always maximize their objectives is lack of information rather than psychology. The chapter also summarizes findings from experiments using monkeys as subjects.

Chapter 6 discusses if nudges can help people make better decisions and whether governments should use them. The use of nudges is controversial, and the authors do an excellent job of explaining the different sides of the debate. Finally, chapter 7 reviews how psychology has influenced marketing and advertising. The book does not contain a concluding chapter summarizing the main arguments or discussing the policy implications of the research.

While the book is interesting and easy to read, one is left with the impression that its disapproval of standard economic theory is overdone. More effort could have been devoted to proposing a theoretical framework supporting the arguments of the book, rather than summarizing a collection of stories, anecdotal evidence, and case studies. Although the book is an engaging read, the most convincing modern economics books rely on persuasive empirical evidence, such as that obtained from large datasets and econometric techniques that can control for unobserved individual characteristics, and this is an area in which *Behavioral Economics: The Basics* slightly disappoints. Still, undergraduate students taking an introductory course in behavioral economics and casual readers interested in selected microeconomic applications of psychology may find this book interesting.

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